UT 97-7
Tax Type: USE TAX
Issue: Medicines & Medical Appliance Exemption (Low Rate)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
v.	)	No.
	)	IBT
XYZ CORPORATION, INC.,	)	NTL:
Taxpayer	)	

RECOMMENDATION FOR DISPOSITION

Appearances: Messrs. David Hughes and Jordan Goodman, Horwood, Marcus & Berk, for XYZ CORPORATION, Inc; Alan Osheff, Special Assistant Attorney General on behalf of the Illinois Department of Revenue.

This matter arose by way of a timely protest filed in answer to a Notice of Tax Liability issued by the Department on December 30, 1994, to XYZ CORPORATION, Inc. ("XYZ CORPORATION" or "taxpayer") for Illinois Use Tax for the period of July 1, 1990, through and including September 30, 1993. At issue is whether the specialized hospital beds and ancillary equipment (fluid delivery pumps) identified by this audit qualify as "medical appliances" under the provisions of 35 ILCS 105/3-10 of the Use Tax Act and the Department's defining regulation, 86 Ill. Admin. Code, Ch. I, Sec. 130.310. If so, then the "high rate"

at which these items were taxed is inappropriate and only the "low rate" would be due.[1]

A secondary question is whether the taxpayer has shown sufficient "reasonable cause" to abate applicable penalties for failure to pay whatever rate should have been imposed at the time it was due. No questions as to the Department's jurisdiction or authority have been raised by this record. On the basis of the evidence presented, it is my recommendation that the taxpayer has prevailed, in majority part, on the first issue. It is also my recommendation that the taxpayer has not overcome the presumption of liability as to penalties imposed.

Findings of Fact:

The Department's Case:

1. The Department made no opening statement. Instead, it simply advised that it was conceding any issue involving respiratory equipment and agreed that no tax should be due on these items.[2] (Tr. p. 4) The Department further alluded at hearing to "possible errors in computation which [would] be corrected later". However, no further mention of these errors was made at any time during or after the hearing. (Tr. p. 5)

2. The Department's *prima facie* case, including all jurisdictional elements, was established by the admission into evidence, without objection, of the SC-10-G, Audit Correction and/or

[1]. The "high rate" of tax refers to the normal state rate of 6.25%. The "low rate" is set by the language of the Act at 1% for medical appliances. (See 35 ILCS 105/3-10, formerly Ill. Rev. Stat. ch. 120, Sec. 439.3-10)

[2]. The statement that "no tax is due" on these items is technically incorrect. Even conceding the fact that the items facially qualify as medical appliances, they would still incur the 1% tax rate.

Determination of Tax Due (Correction of Return prior to 12/93) showing additional tax due of $402,695.00 plus a 10% penalty in the amount of $40,270.00 for a total of $442,965.00. (Tr. p. 12, 13; Dept. Ex. No. 1) Following such admission, the Department rested.[3]

The Taxpayer's Case:

3. Taxpayer's principal offices are in San Antonio Texas. (Tr. p. 33)

4. Taxpayer's business is the design, manufacture and leasing of therapeutic hospital beds[4] and other so-called "medical appliances". (Tr. p. 36; Taxpayer Ex. No. 5)

5. The majority of taxpayer's customers are hospitals and the majority of them are charitable organizations. (Tr. pp. 37, 57)

6. Equipment leased by the taxpayer to customers in Illinois during the audit period at issue in this case consisted of therapeutic beds, fluid delivery pumps and respiratory equipment. (Taxpayer. Ex. No. 1 (Ex. A))

7. The Department audited the books and records of the taxpayer for the period beginning July 1, 1990, and ending on September 30, 1993. (Tr. p. 12)

8. As part of Illinois auditor's examination of depreciation schedules and capitalized assets of XYZ CORPORATION, the auditor

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[3]. Under applicable statutory and case law, the Department is not required to do anything more to establish its prima facie case. (See 35 ILCS 120/4, 5 as incorporated into 35 ILCS 105/12 of the Use Tax Act; *A.R. Barnes & Co. v. Department of Revenue*, 173 Ill. App. 3d 826 (1st District 1988))

[4]. The use of the term "beds" in this document can be construed as a misnomer. Although patients do, as a practical matter, rest, recline and sleep on these devices, that is not their consummate function and purpose. However, for want of a better term, the word "beds" will be used to describe the items. (See Tr. p. 149)

identified specific items leased to Illinois customers, i.e. therapeutic beds, fluid delivery pumps and respiratory equipment as taxable transactions under the Use Tax Act. (Tr. pp. 25-26)

9. The auditor determined that the items in question did not qualify for the low rate as medical appliances on the basis of her own research, reference to the Department's audit manual and conversations with her supervisor. (Tr. pp. 15-16) She also considered several recent departmental ruling letters, although she could not remember the dates they were issued. (Tr. pp. 31-32)

10. XYZ CORPORATION files returns in all 50 states of the United States. (Tr. p. 34)

11. On the basis of tax "matrices" prepared by the taxpayer, the tax to be paid in each state is determined with respect to each transaction. Review of the matrices by XYZ CORPORATION tax personnel led them to believe that no tax would be due to Illinois on the lease of the equipment in question. (Tr. pp. 52-55)

12. The above conclusion was based on the fact that in "most" other states leasing is either not taxed, or the tax is on the lessee, not the lessor as in Illinois. Also, in a majority of states, "medical products" are exempt. It was not determined until after the audit that Illinois has a dual rate. (Tr. p. 55)

13. XYZ CORPORATION tax personnel, however, did concede that at least the 1% local tax should have been paid. It was further conceded that although several ruling letters in other states were consulted, ruling letters for Illinois were not. It was also admitted that no ruling from Illinois was ever requested and Illinois statutes were not consulted in determining the issue of taxability. (Tr. pp. 43-46)

14. The beds at issue in this case are used only when prescribed by a physician. (Tr. pp. 128, 129)

15. Case studies show that the specific benefits provided by the beds in question are instrumental and significant in the promotion of healing and therapeutic recovery from inflicted trauma.[5] (Taxpayer Ex. No. 3)

16. The typical patient for whom therapy on one of the beds at issue would be prescribed is in the intensive care unit, immobilized due to head injury, stroke, spinal cord injury or chronic neurological problems, aged and unable to take care of himself or herself, or who is morbidly obese. (Tr. p. 68)

17. XYZ CORPORATION therapeutic beds cost between $20,000 and $30,000 each, which is about 20 to 40 times the cost of a traditional hospital mattress and frame. (Tr. pp. 162, 163)

18. There are nine types of beds at issue in this case, falling into four separate categories. They are: the kinetic therapy group, the air suspension therapy group, the Fluid Air and the Burke Bariatric. (Tr. pp. 42, 90, 103, 104)

Kinetic Therapy Group:

19. Kinetic therapy is the active and recurring rotation of the patient from side to side to prevent or treat complications of immobility. (Tr. p. 90)

20. The patients for whom kinetic therapy beds would be prescribed are any who are immobilized or restricted to a bed,

[5]. Although no foundation was laid for these case studies and they do constitute hearsay, they were offered and admitted without objection by the Department. As such, I am required to consider them according to their appropriate probative value.

including comatose patients, those with head or spinal cord injuries and advanced elderly patients who have difficulty moving on their own. (Tr. pp. 90, 91)

21. The lungs of these patients continually produce mucous, as do the lungs of healthy people, which traps bacteria and dust particles. (Tr. p. 91)

22. In the lungs of healthy people tiny projections called "cilia" line the bronchial tubes and beat upward to propel mucous through the base of the lungs to the larger airways where the coughing reflex is triggered thus enabling the mucous to be either expectorated or swallowed. (Tr. p. 93)

23. When patients are immobilized or comatose, the mucociliary clearance mechanism which clears the lungs of healthy people is inactivated, so that the mucous sits in the lungs, generally in the most dependent part because it is influenced by gravity. (Tr. p. 92)

24. This condition can result in the development of pneumonia or lung collapse (atelectasis). (Tr. p. 92)

25. The purpose of the kinetic therapy beds is to move the center of gravity to the center of the chest so the collected fluids are rolled from the periphery of the lungs to the center of the chest so that they can be suctioned from the patient by a doctor or a nurse. (Tr. pp. 94, 177)

26. Immobilized patients also incur ventilation profusion problems, which occur when blood goes through the lungs but is not oxygenated. This occurs as a result of the patient lying flat on his back for long periods. Blood does not circulate properly through the

lungs and the patient has to be ventilated, i.e., given supplemental oxygen. (Tr. pp. 102, 103)

27. By using kinetic therapy to turn the patient mechanically, the matching of ventilation profusion is measurably improved so that the amount of ventilation time required is reduced. (Tr. p. 103)

28. Another purpose of kinetic therapy is to mobilize the circulatory system which cannot function properly or efficiently when a patient is unable to move or is otherwise comatose. (Tr. p. 95).

29. One of the other problems immobilized patients have is deep vein thrombosis (blood clotting) because they are lying flat on their backs. This position slows the blood return from the lower extremities back to the heart. (Tr. p. 95)

30. If a clot forms, it can either stay where it formed or it can possibly extend and break off, sending an embolism (an obstructing blood clot) into the heart and lungs. The latter event can be fatal. (Tr. pp. 95, 175, 180)

31. By raising the legs, blood is drained from the lower extremities so that the risk of thrombosis is decreased. (Tr. p. 96)

32. The three beds that are used to provide kinetic therapy are the *RotoRest*, the *BioDyne* and the *Q2 Plus*. (Tr. p. 90, 97)

33. The *RotoRest* is a kinetic treatment table that has supports to hold the patient firmly on the surface. It can then rotate through various arcs of 40 to 60 degrees to each side. (Tr. p. 77)

34. The *RotoRest* is used almost exclusively for patients who have suffered spinal cord injuries, most commonly in the neck. (Tr. p. 174)

35. The *RotoRest* is used to maintain spinal alignment as in the case of a vertebral fracture or a long bone fracture for which the patient is to be put in skeletal or cervical traction and when the doctor wants to rigidly fix the patient to the surface of the bed in order to have them rotated. (Tr. p. 98)

36. The *RotoRest* allows a patient who is paralyzed with a neck injury to rotate while at the same time being held in traction to re-establish the normal cervical alignment. (Tr. p. 174)

37. This rotation prevents bed sores, pneumonia and blood clots in the legs. (Tr. p. 175)

38. The *BioDyne* is typically used for older patients who have various kinds of illnesses, such as strokes or other critical, debilitating trauma that inhibit their movement, but do not need to be placed in traction. (Tr. pp. 182, 183)

39. It is similar in function to a *RotoRest* without the ability or need to maintain traction on the patient's spine. (*Id*.)

40. The *BioDyne* consists of a big frame with cushions that rotate within the confines of the frame, but the whole frame itself does not rotate. (Tr. p. 182)

41. The *BioDyne* functions similarly to a *RotoRest* by substituting for body part malfunctioning. (Tr. p. 183).

42. The *BioDyne* and *Q2* are used for patients without fractures who do not need traction but who have chronic neurological disorders, such as Gilbert's Syndrome or Lou Gehrig's Disease or head injuries. (Tr. p. 98)

Air Suspension Therapy Group:

43. The air suspension therapy group consists of the *Kin-Air*, the *TheraPulse*, the *Home Care DMS* and the *First Step*. (Tr. p. 104)

44. These beds or "therapies" are designed to redistribute the weight of the patient so that there is a greater support surface area, thereby decreasing the amount of pressure on any given body point between the skin and the support surface. (Tr. p. 105)

45. The main goal of this group is to prevent a breakdown of the skin and attendant problems resulting from this breakdown. (Tr. p. 106)

46. Typical patients for whom air suspension beds would be prescribed are patients who are immobilized but do not have pulmonary complications requiring medical ventilation, such as elderly, neurological and stroke patients and for patients in a medically induced coma due to head injuries. (Tr. pp. 105, 106, 185, 216).

47. Particularly for the elderly, if these patients are not physically turned at least every two hours or sooner, bones close to the skin's surface compress the tissue. This extended compression results in interruption of normal fluid flow causing the skin to eventually die, which then ulcerates or sloughs off. (Tr. pp. 107, 108, 109, 186)

48. Skin breakdown can lead to necrosis of the skin and of the underlying muscle and bone, leading to extensive physical damage to a patient. (Tr. p. 186)

49. The purpose or intent of these beds is to relieve the pressure between the bone and the support surface so that blood

circulation and lymphatic fluid distribution are not interrupted. (Tr. p. 110)

50. By allowing the patient's body to sink down deeper into the surface of the bed, a greater surface area of the body is supported so the patient's weight is distributed over a greater area, thereby equalizing the pressure throughout. (*Id*.)

51. This process is accomplished by a series of cushions that are fed by a manifold that is attached to a blower or a motor that pushes air. (Tr. p. 111)

52. The physician prescribes certain features, such as elevation of the head to a certain degree. (Tr. p. 112)

53. The *Kin-Air* bed prevents pressure from being applied in any given place over a prolonged period of time and allows for the shifting of pressure since the patients cannot do it themselves. (Tr. p. 187)

54. In a healthy person's skin, receptors would send a message to the brain that the pressure is beginning to hurt and the brain would then send a return signal to the muscles directing movement to relieve that pressure. Fluid flow would then return to normal. (Tr. p. 188)

55. The *TheraPulse* bed is used for immobilized patients who may have penetrating chest trauma or significant pulmonary problems. (Tr. pp. 191, 216)

56. It is used also for patients with massive wounds, multiple wounds, or if they are at high risk. Burn patients with greater than 50 percent total body surface area loss would be primary candidates for this device. (Tr. pp. 112, 113)

57. In these patients the pulmonary and the musculoskeletal systems are not functioning properly to enable them to breathe deeply, cough and bring up secretions. (Tr. p. 193)

58. The *TheraPulse* bed delivers a pulse to the patients chest like continuous respiratory therapy to break up any secretions in the lungs. (Tr. p. 192)

59. In the air suspension group, *TheraPulse* is the most aggressive therapy. (Tr. p. 113)

60. The *TheraPulse* bed consists of 23 long rectangular cushions, every other one of which is attached to a different manifold so that the air pressure to the various sections of cushions can be controlled. (Tr. pp. 113, 211)

61. This allows the pressure in one area to be increased while pressure in another area is decreased. The resultant "pulsating" action pushes the lymph flow or lymphatic fluid back through the system and enhances circulation. (*Id*.)

62. *Kin-Air* has the same amount of cushions as does TheraPulse but does not have the active pulsation. (Tr. p. 114)

63. *First Step* is an air suspension therapy product which does not have a standard hospital frame that articulates or raises the head or foot section. (Tr. p. 116)

64. It provides the same therapy as *Kin-Air* from the standpoint of air suspension therapy. (*Id*.)

65. The *Home Care* bed is the same as *First Step* in that it is used with patients who have pressure ulcers and it redistributes the pressure thereby allowing the circulatory system to open up and flush out toxins produced when circulation is cutoff. (Tr. p. 117)

66. The *Home Care* bed is used for patients who are unable to move on their own. (Tr. p. 118)

67. The manufacturer's intent with respect to the air suspension beds is that they replace certain aspects of the body that are malfunctioning so that the patient cannot move. (Tr. pp. 118, 119)

68. Most of these products have a Gore Tex fabric covering that provides a smooth, soft surface minimizing friction and shearing to help prevent tissue damage. (Tr. p. 119; Taxpayer. Ex. No. 5)

69. In a healthy human being, the skin prevents the entry of bacteria and controls the amount of moisture leaving the skin. (*Id*.)

70. For patients that have pressure ulcers or wounds that are open and allow bacteria to enter and do not allow control of the amount of moisture leaving the skin, Gore Tex is used as a means to control moisture vapor transmission which is a typical function of the skin and it is a good thermal insulator which helps to regulate heat so that cells do not swell, crack and split and admit bacteria. (Tr. p. 120, 121)

The Fluid Air Bed:

71. The *Fluid Air* bed is a fluidized therapy system consisting of a large tank filled with microspheres or very small beads and from underneath a blower system pushes air through the beads making the beads behave like a fluid. (Tr. p. 122)

72. The patient rests on a cover sheet or a Gore Tex sheet covering the bed. (Tr. p. 123)

73. The types of patients typically treated on this kind of bed are those having massive burns, skin grafts, and elderly patients with

contractures (deformities caused by shrinkage of muscle or scar tissue) and large pressure ulcers. (*Id*.; Tr. p. 196)

74. The *Fluid Air* redistributes pressure to the skin and body surfaces so that capillaries are maintained in an open state thereby allowing blood to get to the tissues. (*Id*.)

75. The *Fluid Air* has a higher air flow than the air suspension surfaces and if a physician has donor sites that he is taking graft tissue from and he wants to dry those tissues out, he can use the high air flow to help do that. (Tr. p. 124)

76. The *Fluid Air* has minimal sheer and friction which reduces the likelihood of graft failure caused by kinking and blocking of the blood vessels. This occurs if the patient slides down and the attached tissue does not move with the rest of the body. (*Id*.)

77. Once the skin is burned and no longer a barrier to bacteria or to water loss, these wounds are very wet and soupy and the *Fluid Air* system helps dry those or maintain that moisture loss. (Tr. p. 125)

The Burke Bariatric Bed:

78. The *Burke Bariatric* is a larger support surface intended to help morbidly obese patients mobilize themselves, sit up, and egress from the bed. (Tr. pp. 126, 127)

79. Morbidly obese patients who typically weigh in excess of 350 pounds up to 850 pounds cannot breathe if they are in a fully reclining position due to the weight of their own stomachs exerting pressure on their diaphragm. Nor can they pull themselves up to either a sitting or standing position. (*Id*.)

80. From a respiratory standpoint, the *Burke Bariatric* allows the mass of the abdomen to relax or to go down away from the diaphragm so that the patient can breathe more easily and maintain lung volumes. It also helps the musculoskeletal system so that the patient can achieve the sitting position or achieve a standing position. (*Id*.)

81. *Burke Bariatric* beds are prescribed for these morbidly obese patients when they come to the hospital for problems directly associated with their obesity. (Tr. p. 128)

Fluid Delivery Pumps:

82. The fluid delivery pumps at issue are used to give patients who are unable to eat or drink on their own measured dosages of drugs chemicals, pharmaceuticals or fluid such as dextrose and water or normal saline. (Tr. pp. 129, 130)

83. These patients may not be able to swallow for a variety of reasons such as they are unconscious, have an endotracheal tube inserted to assist breathing or they may have had surgery where it is not recommended that they eat or drink either before or after. (Tr. p. 131)

84. Other than the general statement of their specific purpose, there was no testimony given nor documentation offered which would show or tend to show that these devices (the fluid delivery pumps) substituted for a malfunctioning part of the body, either directly or indirectly.

Conclusions of Law:

Taxing statutes are to be strictly construed and in cases of doubt, are to be resolved *against* the government and in favor of the taxpayer. Van's Material Co. v. Dept. of Revenue, 131 Ill. 2d 196

(1989). Exemptions, on the other hand, are to be construed in favor of taxation, with all doubts being resolved against the entity seeking the exemption. Craftmaster, Inc. v. Department of Revenue, 269, Ill.App.3d 934 (4th Dist. 1995), and cases cited therein.

However, as pointed out by XYZ CORPORATION in its post-hearing brief,[6] this case does not involve any *exemption* to the imposition of tax, but instead concerns itself with a reduced rate of tax applicable to those items which qualify as medical appliances. As such, any and all presumptions, intendments and preferences which would normally apply to exemption matters do not pertain to this controversy. Canteen Corp. v. Department of Revenue, 123 Ill. 2d 95; 525 N.E. 2d 73 (1988). This is a position in which the Department, through a series of general information letters, apparently concurs as a matter of legal interpretation and general policy.[7]

The Department made its *prima facie* case when it introduced the SC-10-G Audit Correction and/or Determination of Tax Due. (35 ILCS 120/4 as incorporated into the Use Tax Act under 35 ILCS 105/12) The burden of going forward with proof then shifted to the taxpayer. At the hearing in this case, two medical doctors testified on behalf of

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[6]. The Department of Revenue did not file any brief, responsive or otherwise, either in support of its position or otherwise refuting the arguments made by taxpayer.

[7]. See General Information Letters: 96-441; 96-445; 96-453; 96-475; 96-518; 96-529; 97-0025; 97-0057; 97-0071; 97-0088, all of which acknowledge and make reference to the fact that medical appliances are not exempt but instead are subject to tax at a lower rate. This is true even though the Department's regulation continues to utilize the term "exemption". The conclusion is further supported by the fact that medical appliances are not included under the list of specific exemptions enumerated in the Use Tax Act (35 ILCS 105/3-5, formerly cited as Ill. Rev. Stat. ch. 120, Sec. 439.3-5) but instead are specifically taxed at 1% under the language of 35 ILCS 105/3-10, formerly Ill. Rev. Stat. ch. 120, Sec. 439.3-10.

the taxpayer regarding both the taxpayer's intent in manufacturing the items at issue and their specific uses and functions in the practice of medicine.

The first, DR. A, is the president of the taxpayer's medical department. (Tr. p. 62) He has been employed by XYZ CORPORATION since he graduated from medical school in 1985. (Tr. p. 63) The second was DR. B, who is an assistant professor in the department of neurosurgery and orthopedics at Loyola University Medical Center in Maywood, Illinois. (Tr. p. 169, 170; Taxpayer Ex. No. 6) DR. B was qualified to testify as an expert with the consent of the Department. (Tr. p. 170)

Both DR. A and DR. B provided great detail regarding the intention of the manufacturer with regard to each appliance at issue, its respective function and use and the manner in which it acts as a substitute for one or more malfunctioning body parts or bodily systems. Their testimony was credible, and being almost totally uncontroverted, is given great weight in this recommendation as an aid to the trier of fact.

The testimony of DR. A and DR. B was sufficient to overcome the Department's ***prima facie*** case. When the taxpayer presents sufficient evidence to overcome the Department's ***prima facie*** case, the burden of going forward shifts back to the Department to show by a preponderance of competent evidence that the tax remains due. Goldfarb v. Dept. of Revenue, 411 Ill. 573 (1952) This burden was not carried in the context of these proceedings.

The Department presented no expert or other testimony, nor any documentation which acted to controvert, cast doubt upon or reduce the

impact of the opinions of either DR. A or DR. B regarding the manufacturer's intent and the function of the items at issue. In fact, no real attack on the conclusions drawn by these witnesses was at any time offered. The Department's only witness in this case was its auditor, and that was only upon rebuttal.

The auditor was not competent to testify as to the purpose or function of the appliances, as by her own admission she had made no real investigation into that area. (Tr. pp. 15-21) The audit itself was limited to depreciation schedules for leased equipment which the taxpayer maintained for federal income tax purposes. (Tr. pp. 14, 224) It was determined that the therapeutic beds at issue were taxable at the high rate primarily because the Department's audit manual instructs that hospital beds are to be taxed at the high rate. (Tr. pp. 14-16, 27-30) The auditor did not consult with any of the taxpayer's engineers or other technical personnel. (Tr. pp. 18, 19) She made no analysis nor drew any independent conclusions of her own. Absent any evidence to support its determination following the taxpayer's presentation, the Department failed to carry its burden of proof

The evidence on record in this case consisting of the hearing transcript and the exhibits admitted, establishes that the taxpayer has overcome the Department's *prima facie* case of tax liability under the assessment in question. Accordingly, under the reasoning set forth below, the determination by the Department that XYZ CORPORATION Therapeutic Company owes the tax liability as indicated in Notice of Tax Liability SF-1994434788701002, must be set aside. In support thereof, the following conclusions are made:

This case involves the application of Section 3-10 of the Illinois Use Tax Act[1], 35 ILCS 105/3-10, formerly cited as Ill. Rev. Stat. ch. 120, Sec. 439.3-10, which provides in pertinent part:

> Unless otherwise provided in this Section, the tax imposed by this Act is at the rate of 6.25% of either the selling price or the fair market value, if any, of the tangible personal property...
>
> With respect to . . . prescription and non prescription medicines, drugs, *medical appliances*, and insulin, urine testing materials, syringes, and needles used by diabetics, for human use, the tax is imposed at the rate of 1%.[9] (Emphasis supplied)

The applicable regulation interpreting this statutory section, 86 Admin. Code Ch. I § 130.310, provides, in relevant part, as follows:[10]

c) Medicines and Medical Appliances

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[1]. As a lessor of tangible personal property to entities within the State of Illinois, the taxpayer is deemed to be the ultimate user of the property and is thereby subject to the Use Tax Act. There are no issues regarding "nexus" or "doing business within this State" raised by the record.

[9]. The language of this Act mirrors that of the Retailers' Occupation Tax Act, 35 ILCS 120/2, formerly cited as Ill. Rev. Stat. ch. 120, Sec. 443, which is incorporated into the Use Tax Act under the provisions of Section 12 of that Act. 35 ILCS 105/12, formerly Ill. Rev. Stat. ch. 120, Sec. 439.12.

[10]. A point not argued nor pursued by either party is that the audit period which is the subject of this proceeding overlaps a point at which the Department's medical appliance definition was substantively changed. Prior to January, 1992, the applicable regulation defining medical appliances read in pertinent part as follows:

> A medical appliance is an item which is intended by the maker *to correct any functioning part of the body* or which is used as a substitute for any functioning part of the body... (emphasis supplied) 86 Ill. Admin. Code. Ch. I, Sec. 130.310(c)(2)(3). (emphasis supplied)

As such, the application of the regulation on those items pertaining to the earlier part of the audit (1990-91), would be governed under a significantly different and apparently lesser standard. The earlier regulation allowed for a reduced rate of tax to apply to those items which were intended and served to correct a functioning (sic) part of the body, as well as those which were used as a substitute therefor. Under that lesser standard, there is no question by this record that these therapeutic beds met the applicable test.

> 2) A medical appliance is an item which is intended by its manufacturer for use in directly substituting for a malfunctioning part of the body. Such items may be prescribed by licensed health care professionals for use by a patient, purchased by health care professionals for the use of patients or purchased directly by individuals. Purchases of medical appliances by lessors which will be leased to others for human use also qualify for the exemption. Included in the exemption as medical appliances are such items as artificial limbs, dental prostheses and orthodontic braces, crutches and orthopedic braces, wheelchairs heart pacemakers, and dialysis machines (including the dialyzer). Corrective medical appliances such as hearing aids, eyeglasses and contact lenses qualify for exemption. Other medical tools, devices and equipment such as x-ray machines, laboratory equipment, and surgical instruments which may be used in the treatment of patients but which do not directly substitute for a malfunctioning part of the human body do not qualify as exempt medical appliance. 86 Admin. Code ch. I, § 130.310(c)(2)
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> 3) Supplies, such as non-sterile cotton swabs, disposable diapers, toilet paper, tissues and towelettes and cosmetics such as lipsticks, perfume and hair tonics do not qualify for the reduced rate. Sterile dressings bandages and gauze do qualify for the reduced rate. Diapers for incontinent adults, as well as undergarments for incontinent adults, qualify for the low rate of tax.
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> d) Insulin, urine testing materials, syringes, and needles used in treating diabetes in human beings qualify for the reduced rate of tax.

The statute taxing medical appliances at the rate of 1% does not itself define the term "medical appliances."[11] It only provides that they must be for human use. The regulation, 86 Admin. Code Ch. I Sec. 130.310(c)(2), as seen in the paragraph above, defines the term as "an item which is intended by its manufacturer for use in directly substituting for a malfunctioning part of the body". It states that medical appliances purchased by lessors for lease to others for human

[11]. At least one court has found the term "medical appliance" as it appears in the statute to be "ambiguous". See Medcat Leasing v. Whitley, etc. et al., 253 Ill App. 3d 801, 803; 625 N.E. 2d 424, 426 (4th District, 1993)

use also qualify for the "exemption" (sic). It then provides examples of items that would qualify for the low rate.

In the case at hand, the taxpayer leases the beds and the fluid pumps to hospitals on prescription for human use. Therefore, the question remaining is whether they are the type of item contemplated by the statute and the regulation for taxation at the low rate.

The issue of what is or is not a "medical appliance" within the intent of the legislative language has plagued the Department of Revenue for years. It may well be that medical science has outpaced the law as it has in so many other areas. But that is not to be debated here. What is evident, is that the judgment exercised as to what items the term will apply has often been varied and inconsistent, even in relation to the defining regulation. This is seen in the simple fact that hospital beds prescribed by physicians were held to be medical appliances subject to the low rate of tax by the Department prior to 1990.[12] This position was subsequently rescinded to be replaced by the currently operative policy that hospital beds are to be taxed at the high rate.

Notwithstanding the above, it is the evidence of record which must govern the decision in this case. It is here that the Department fails to put forth any rational argument, much less supportive evidence, to justify the position it has taken. It is quite possible that facts, circumstances and arguments do exist which would warrant denial of these items as medical appliances, but without something

[12]. See Private Ruling Letters 86-0627 (July, 1986) and 88-0801 (October, 1988). These are not, however, binding upon the Department as to this taxpayer.

more than was given in these proceedings, I am unable to come to any other conclusion than what has been put on these pages.

Drs. DR. A and B both testified extensively as to the manufacturer's intent and as to the purpose and function of the beds in question. Their uncontroverted and largely unchallenged testimony was that the manufacturer intended these beds to substitute for malfunctioning body parts and that they indeed operate as such.

The first category of beds at issue and about which they testified is the kinetic therapy group, consisting of the *Rotorest*, the *Biodyne* and *Q2 Plus*. The *RotoRest* is a kinetic treatment table that has supports to hold the patient on the surface while it rotates from side to side through arcs of from 40 to 60 degrees. It is used for patients with spinal cord injuries who must be held in a rigid position to maintain spinal alignment.

The *BioDyne* and the *Q2 Plus* are used for patients who are immobilized but do not need to be held in a rigid position. Immobilized patients for whom these beds are prescribed suffer from pulmonary problems because mucous builds up in their lungs due to the lack of movement. This makes them susceptible to pneumonia and to lung collapse. Similarly, because of the immobility, blood clots tend to form in their legs. These clots can break off and travel through to the patient's heart and lungs which can be fatal. Another problem is that immobilized patients are susceptible to bed sores because of their inability to move.

In a healthy person's lungs, normal bodily movement causes mucous to be expectorated by the pulmonary system. Similarly, a healthy person's normal body movements prevent blood clots from forming in the

legs and bed sores from forming on those body areas where the bone is close to the surface, thereby causing undue pressure. In providing the rotation movement, in a very general sense, these beds substitute for the spinal cord[13] which cannot send the necessary signals to the patient's muscles required for them to function normally. By rotating the patient, these beds have the effect of substituting for the normal movement of a healthy person. In this way they act as a replacement for the specific aspects of the neurological system that have lost the ability to send or receive nerve impulses to the muscles of the body.

Similar testimony was proffered from both doctors regarding the suspension therapy group (i.e. *Therapulse*, *Kin-Air, Home Care DMS* and *First Step*), the *Fluid Air* and the *Burke Bariatric*. For each type in turn, precise examples were given as to how the beds perform similar functions to definitive body systems or organs which can no longer work in the way they should because of a patient's condition. None of this testimony was met, challenged or refuted through any argument or evidence presented by the Department.

The final items at issue are the fluid delivery pumps which are used to give a measured dose of either drugs, chemicals, dextrose, pharmaceuticals or fluid to a patient. They are used on persons who are unable to ingest these substances on their own because they are unconscious or have endotracheal tubes inserted or they may have had surgery which temporarily prevents them from swallowing as they usually could.

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[13]. Taxpayer does not suggest that the therapeutic beds actually substitute for the spinal cord, which is conceded as impossible. The spinal cord, as the hub of the body's central nervous system is merely used for illustrative purposes.

However, notwithstanding their stated purpose, the taxpayer introduced no real evidence nor offered any expert opinion that these devices substitute for any malfunctioning human systems or body organs. Although brief testimony was offered to explain why they are used, (Tr. pp. 129-131), there was no statement, medical conclusion or other indicative evidence that would establish a direct or inferential qualification under the regulation.

Taxpayer poses through argument alone that these items qualify because they "directly substitute for a portion of a patient's digestive system". (Taxpayer brief, p. 27) The difficulty with this rather broad declaration is that there is no evidence of record to support it or by which it may be corroborated. Neither of the experts testifying offered any opinions to this effect and rendered no conclusions on the subject.

While the fluid delivery pumps may provide a means by which nutrients, fluids and/or medicines can be introduced into the body, that does not automatically translate into a demonstration that they somehow substitute for a portion of a patient's digestive system as is suggested. The fact that someone may have an endotracheal tube in their throat after surgery does not equate with the assumption that some identifiable part of the body is not working. That a patient may be *prevented* from swallowing due to the presence of other medical apparati or that their ingestion is restricted due to some surgery and doctor's orders, does not necessarily mean that their mouth, throat, esophageal tract or stomach are not otherwise functioning normally. Simply because a person may be unconscious or asleep does not establish that their bodies are operating in any way other than a

normal, usual fashion. To accept taxpayer's position with respect to these items therefor is strictly a leap of faith. As such, XYZ CORPORATION has not overcome the presumption of correctness with respect to these devices and the attempt to qualify as medical appliances must be denied.

Reasonable Cause:

As the secondary issue of this case, XYZ CORPORATION argues that all applicable penalties imposed for their failure to pay the tax when due should be abated due to "reasonable cause". Since this recommendation has determined that the taxpayer established its qualification for the low rate, at least as to the therapeutic beds, penalties would be calculated on the 1% tax that was not paid on these items and the full "high" rate for the fluid delivery pumps.

In examining the question of whether sufficient grounds exist to abate penalties, the rules of statutory interpretation require that I utilize the law as it existed at the time the liability arose to determine the taxpayer's rights and responsibilities. See Musa Sweis v. Sweet, 269 Ill. App. 3d 1 (1st District 1995). As such, the Uniform Penalty and Interest Act, ("UPIA") 35 ILCS 735/3-3, and the regulation which accompanies that Act, 86 Ill. Admin. Code, Ch. I, Sec. 700.400, both of which deal with reasonable cause, cannot be used. The UPIA did not go into effect until January of 1994, well after the audit period which encompasses this issue. Its application is not retroactive either by statement or implication.

Instead, the only provision within the Retailers' Occupation Tax Act (as it may be incorporated into the Use Tax Act) which in any

manner dealt with "reasonable cause" and is applicable to the audit period, is Section 5, 35 ILCS 120/4, formerly cited as Ill. Rev. Stat. ch. 120, Sec. 444. (1992). The provisions of that section, in pertinent part are as follows:

> ...where the failure to file any tax return required under this Act on the date prescribed therefor (including any extensions thereof), is shown to be unintentional and nonfraudulent and has not occurred in the 2 years immediately preceding the failure to file on the prescribed date or is due to other reasonable cause, the penalties imposed by this Act shall not apply.

The taxpayer argues that it demonstrated "good faith" through the exercise of ordinary business care and prudence in its determination of whether taxes should be due. Thus, reasonable cause has been shown. I cannot agree.

Testimony was given by two members of XYZ CORPORATION's corporate tax staff[14] that elaborate mechanisms were utilized by the company to determine its tax status in all 50 states, including private letter rulings from states other than Illinois. (Tr. p. 41) It was thereafter concluded that no tax would be due to Illinois on the premise that the items in question were medical appliances and should be exempt. (Tr. pp. 38, 55) However, several glaring errors appear to exist in the considerations made not to file or pay the tax.[15]

Most significantly, it was admitted by ACCOUNTANT, the tax accountant who prepares XYZ CORPORATION's returns in all 50 states, that he never examined any prior ruling letters nor asked for any specific rulings on the issue from the State of Illinois. (Tr. p. 44)

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[14]. ACCOUNTANT, tax accountant and TAXPAYER'S PAYROLL DIRECTOR, Director of Tax and Payroll for XYZ CORPORATION.

[15]. Ms. TAXPAYER'S PAYROLL DIRECTOR conceded on cross examination that at least the 1% low rate should have been paid. (Tr. p. 60)

Moreso, he did not even check the statutes of Illinois to ascertain how either lease transactions were handled or whether medical appliances were "exempt" within this State. (Tr. p. 46) It is not even clear from his testimony whether he made any reasonable attempt to determine whether a use tax was relevant to the situation at all.[16]

TAXPAYER'S PAYROLL DIRECTOR, XYZ CORPORATION's tax and payroll director, did not even learn that Illinois has a reduced tax rate for medical appliances until after the audit. (Tr. p. 60) There is no evidence of record that any respectable attempts were made by her to check the law on the subject. Assumptions, erroneous ones, were made by both of these individuals on the basis of how other states operate. It was mainly these assumptions that guided their respective actions in this case, not the exercise of care.

Because a simple check of the statute as it applies to medical appliances would have quickly revealed a minimum 1% rate, I cannot concur that a failure to check or otherwise research readily available sources falls under the umbrella of ordinary business care and prudence. A mistaken reliance on how other states treat the subject matter does not constitute reasonable cause. Accordingly, the statutory penalties would apply.

WHEREFORE, it is my recommendation that Notice of Tax Liability XXXXX be amended in conformity with the reasons stated above to tax the named therapeutic beds at the reduced 1% rate and the fluid

[16]. This was due to his testimony that most states do not have a "Use Tax" and therefore it was not considered in evaluating whether any tax should be paid. (Tr. p. 38)

delivery pumps at the full 6.25%, all applicable penalties and interest to pertain.

Richard L. Ryan
Administrative Law Judge